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Real Estate Economists, Appraisers and Counselors

COMMERCIAL LAND VALUES

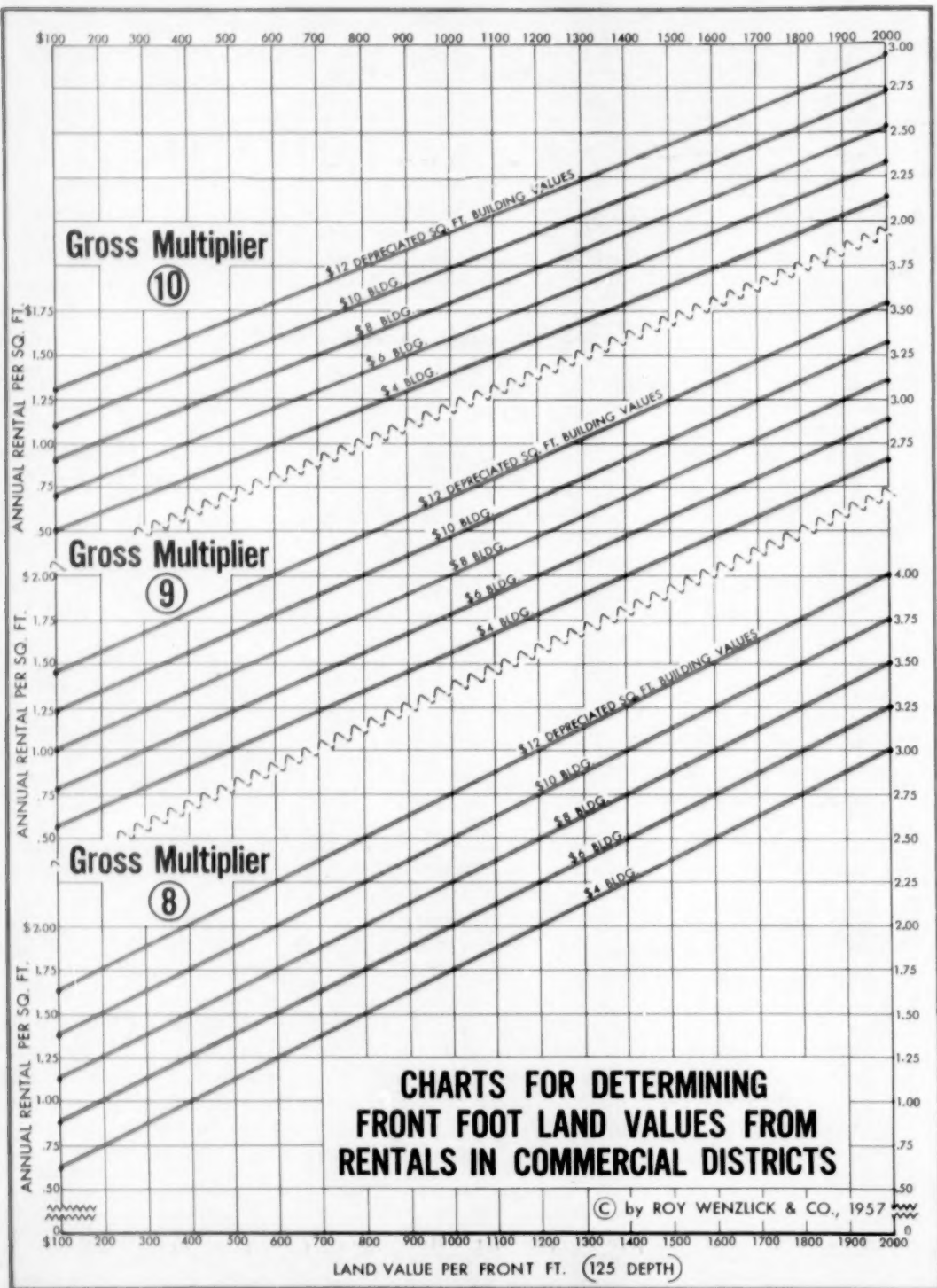
ESTIMATING commercial land values is frequently one of the most troublesome jobs in appraising real estate. Basically there are only two methods of arriving at commercial land values: by the comparative approach and by the land residual application of the income approach. In our mass appraising work we have developed several techniques to supplement these standard methods which are sometimes so hard to apply when they are used in long-established commercial districts.

The comparative approach depends primarily on analysis of land sales data, which is usually either nonexistent or misleading. For appraisals in or near the 100% district it is very unusual to find a recent bona fide sale of unimproved land. Ground lease information is valuable in the comparative approach, but in most cases it is usable only if the lease is fairly recent and represents an economic rent for the land. Sales of property for parking purposes are sometimes available, but these prices may include premiums paid in desperation by particular parties. For these reasons it is often very difficult for the appraiser to put together a convincing comparable approach for his commercial land valuation.

Likewise the land residual application of the income approach has its drawbacks. Inherently it requires the assumption of "highest and best use," an economic rent for the entire property, and generally a fairly accurate estimate of accrued depreciation. This land residual approach is most useful when applied to more recent construction. Again it is in the older districts where the appraiser may be in difficulty using this method on an individual property.

Sometimes appraisers can effectively estimate commercial land values by assuming the erection of a hypothetical new building on the site. After its construction cost is determined, an economic rent is assigned to this building. This rental should be based on comparable rentals found in the district. Expenses are then estimated, and a fair portion of the net return is assigned to the new building. The balance of the income is then capitalized in order to arrive at the value of the land.

We have found that in using this method it is possible to come up with some extreme answers unless particular care is taken to "build" the highest and best use for the land. Another problem is correctly estimating the fair rental for the



new improvement when all of the comparable rentals are based on older properties. In some older commercial districts the highest and best use of the ground is probably a depreciated building rather than a new one. This means, in effect, that a developer buying a vacant lot in such a district and erecting a new building on it could not obtain a large enough rental to justify the land and building costs. This is particularly the case in the business districts of old and small cities.

In establishing commercial land values we use the premise that there is a direct relationship between ground floor rentals and land values. Generally speaking, rentals from upper floors must be assigned as a return to the building, while a return to most commercial land must be obtained from first floor rentals. Over the years, walk-up space on second, third, and fourth floors in our buying centers has become less and less desirable. In fact, it is unusual today to find other than unprofitable storage use above the second floor in most walk-up commercial buildings. Coinciding with this economic trend, we generally find a distinct difference in the quality of the first floor space as compared with the space on the upper floors. First floor space is more frequently modernized inside and out, while upper floors are left to deteriorate because of their non-productiveness. Often the stores with the best appearance along the highest value frontage have taken over the street entrance to the upstairs, which means that the reproduction cost of the entire building has little meaning and that no single physical depreciation can be applied to the two distinct parts of the property.

We have studied and have attempted to use various charts and tables prepared by others to relate first floor rentals to land values. In all, however, we find two principal shortcomings. First, these exhibits have not taken into consideration variances in the capitalization rate which should be applied, and second, they fail to recognize the accrued depreciation of the improvements. For example, we have two stores of the same size with identical rents. Are the land values necessarily the same? Factors which must be considered are relative locations, age of buildings, quality of tenants, and lease terms. The land values of these two properties could differ widely.

On the opposite page are shown three of the charts which we have developed to use with commercial land value estimates. Actually the results are based on the land residual approach. It is not intended that the charts be used for one specific property but rather as a "rule of thumb" method to be used on all of the properties where comparable rentals have been obtained. Instead of preparing detailed land residual income appraisals of comparable properties to determine land values, we submit that the appraiser can use these charts to obtain indications of land value.

At the top of the chart a multiplier of 10 is used, in the center 9, and at the bottom a multiplier of 8 is used. On each chart the annual square foot rentals are at the left and the resulting land values along the base. On each chart we have shown lines representing the depreciated value of one-story retail space ranging from \$4 to \$12 per square foot. By a series of charts such as this we

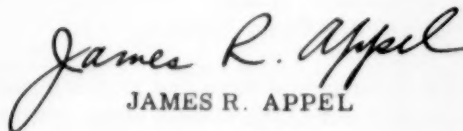
are able to take into account variances in the capitalization rate and, especially, we can use actual rentals with the depreciated value of actual, rather than hypothetical buildings.

The rentals used are gross annual rents per square foot. We have assumed the usual situation where the owner has expenses of management, insurance, taxes, and exterior maintenance only, while the tenant assumes the cost of heat, utilities, janitor service, and interior maintenance. To use some rentals for comparison, of course, it will be necessary to adjust for different divisions of these items.

When the appraiser is obtaining comparable information in the district he should record the size of the various stores where he obtains rents. At the same time he can estimate the depreciated values of the spaces for which these rentals are secured. It is also important in making these estimates to remember that replacement costs will decrease as floor areas increase and vice versa.

In addition, when using the annual rent per square foot it is advisable to use, for comparable properties, stores with floor areas similar to properties being appraised. If it is necessary to use larger or smaller floor areas, the appraiser should consider that the annual rate per square foot will be much higher on small space, and perhaps considerably lower on extremely large floor areas.

In selecting the correct chart, the appraiser should consider the usual factors which enter into the selection of a capitalization rate. Especially he should weigh the use of the property, tenancy, length of lease, and remaining economic life of the improvement. Naturally the more attractive the property is from an investment standpoint, the higher will be the gross multiplier used and vice versa.


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